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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions"	)	CC Docket No. ~~91-101~~ 92-101
	)	
Bell Atlantic Tariff FCC No. 1	)	Transmittal No. 497
	)	
U S West Communications, Inc. Tariff FCC Nos. 1 and 4	)	Transmittal No. 246
	)	
Pacific Bell Tariff FCC No. 128	)	Transmittal No. 1579

REBUTTAL TO OPPOSITIONS TO DIRECT CASE OF THE UNITED STATES TELEPHONE ASSOCIATION

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SUMMARY

USTA provides a detailed response to the objections raised by the opposing parties prepared by Godwins regarding its study. The response clearly refutes the objections and demonstrates that the Bureau can rely on the soundness of the study and the validity of its results in recognizing OPEB costs as exogenous for price cap purposes.

USTA also rebuts assertions made that OPEB costs have already been reflected in the Commission's latest represcription.

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UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association (USTA) respectfully submits its Rebuttal to the Oppositions to Direct Case which were filed July 1, 1992 in the above-referenced proceeding.

I. INTRODUCTION.

In its Direct Case, USTA supported the exogenous treatment of the incremental costs of implementing Statement of Financial Accounting Standards -106 (SFAS-106), "Employers Accounting for Postretirement Benefits Other Than Pensions" (OPEB). USTA commissioned the Godwins study, "Post-Retirement Health Care Study Comparison of TELCO Demographic and Economic Structures and Actuarial Basis National Averages" (1992). That study analyzes the impact of SFAS-106 on GNP-PI and, in particular, the extent to which the GNP-PI will reflect the increase in costs experienced by exchange carriers as a result of implementing SFAS-106. The study shows that the impact of implementing SFAS-106 will not be double-counted within the context of the price cap formula.

In Oppositions filed July 1, 1992, AT&T, MCI, Ad Hoc Telecommunications Users Committee (Ad Hoc) and ICA attempted to raise objections to the Godwins study. MCI, Ad Hoc and ICA also allege that the impact of implementing SFAS-106 was reflected in the latest Commission represcription of exchange carriers' rate of return. USTA will refute these points in its Rebuttal.

II. <u>GODWINS STUDY</u>.

Attached hereto is a detailed response to the objections raised by the opposing parties prepared by Godwins. The response clearly refutes the objections and demonstrates that the Bureau can rely on the soundness of the study and the validity of its results in recognizing OPEB costs as exogenous for price cap purposes.

The response first discusses the issue of double counting. The Godwins study addresses double counting which could occur in the increases in the PCI due to increases in the GNP-PI caused by companies with OPEB liabilities reflecting those costs through higher prices. No opposing party casts doubt on any of the basic findings of the study. Therefore, the Bureau should adopt the study's conclusion that double counting could account for 0.7

percent of the increase in costs attributable to SFAS-106, that 14.5 percent of the increase could be recovered through a reduction in the national wage rate and that the remaining 84.8 percent of the increase in costs are exogenous.

The response clarifies a misconception of the opposing parties by explaining that it is the increase in expense due to the SFAS-106 accounting change that should be afforded exogenous treatment, and not the SFAS-106 expense.

The response explains that the alternatives suggested by opposing parties to determine the extent of double counting do not even address the true source of potential double counting.

Second, the Godwins response refutes objections raised regarding the actuarial analysis. Godwins points out that AT&T's contention that the study is flawed because the government sector is excluded is based on a misstatement of fact. MCI's criticism regarding the use of data from only one insurance company only demonstrates that MCI failed to appreciate the validity of the data and how it was utilized in the study. Godwins also addresses Ad Hoc's contention that it did not include the effect of "standard error".

The response supports the reasonableness of the actuarial assumptions utilized in determining the ratio of GNP-BLI to TELCO-BLI. In addition, Godwins reaffirms its finding that labor costs of non-exchange carrier firms sponsoring retiree medical plans will increase 3.19 percent as a result of SFAS-106.

Godwins also responds to objections regarding the macroeconomic analysis.

Finally, Godwins rebuts the report prepared by Economics and Technology, Inc. (ETI). As Godwins explains this report is unprofessional in that it contains numerous misrepresentations and distortions.

III. RATE OF RETURN REPRESCRIPTION.

The opposing parties have missed the point in assuming that the latest Commission represcription of rate of return made exchange carriers whole.[1] Specifically, ETI contends that exchange carriers have ignored economic effects to the extent that SFAS-106 liabilities were reflected in RBOC share prices as used by the Commission in setting the rate of return. MCI states that SFAS-106 costs were embedded in the initial price cap rates and that to provide exogenous treatment for these costs would result in double counting. This claim is supported in an affidavit attached to MCI's filing by Professor Allan Drazen.

In stating these claims, the opposing parties are simply making the wrong argument on several counts. First, they have ignored the fact that exchange carriers are regulated on their

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[1] See, Comments of Ad Hoc at p.17 and MCI at pp.11-17.

accounting records. In monitoring a company's books, the regulator must recognize any change in accounting rules that affects the company's earnings which is not otherwise accounted for and make an adjustment for the change. The regulator, by setting a fair rate of return, has not obviated the obligation to compensate the company for any reasonable and necessary expenditures.

Second, the opposing parties have completely missed the link between risk and return. They have not shown any changes in the cost of capital caused by changes in company risk or changes in capital market conditions. They have simply contended that a postulated change in the stock price of a company automatically implies a change in the cost of capital. Their arguments are both unsupported and erroneous. Changes in the cost of capital are caused by changes in risk, not simply by a change in stock price, as the opposing parties contend. In fact, the Commission has stated that "(a)n increase in the price of a stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated profits rather than lower investor perceived risk."[2]

The existence of post-employment medical liabilities is not new to analysts and investors. The extent to which these

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2 Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, released December 7, 1990 at paragraph 133.

liabilities were incorporated in the stock price of a company was not affected by or based on the adoption of SFAS-106. Such liabilities were always an economic reality. The only thing the adoption of SFAS-106 did was to affect the accounting of these costs and, potentially, the recovery of these costs through rates. If stock prices were reduced by these liabilities, it was not due to SFAS-106. Further, even if stock prices were reduced by expectations, the need for exogenous treatment has not been eliminated.

As the Commission was considering the represcription of rates for exchange carriers, recovery of SFAS-106 costs was a reasonable expectation of the investment community. Exchange carriers expected that changes to GAAP would be exogenous and that an accrual account for retiree nonpension benefits would require a GAAP change. The record before the Commission reflected a consensus on this issue:

> USOA Changes. All those commenting on the treatment of costs attributable to changes in our Uniform System of Accounts agree that these costs should be considered exogenous. ... Nonetheless, because changes in GAAP cause changes in the regulatory accounting procedures of carriers under our jurisdiction only after we find such changes compatible with our regulatory accounting needs, we conclude ... that AT&T should adjust its price cap to reflect such changes in GAAP only after we have approved such a change. We now propose the same treatment of GAAP changes for the LECs.[3]

Exchange carriers expected that accrual accounting for

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[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, released April 17 1989, at paragraph 654.

retiree nonpension benefits would require a GAAP change.

The Commission did not further address exogenous cost treatment of either GAAP changes, USOA changes or SFAS-106. Thus, no indication was given to investors by the Commission that price cap exchange carriers would not receive exogenous cost recovery for the incremental SFAS-106 costs imposed by the GAAP change. In fact, it was expected that price cap exchange carriers would obtain increased revenues to cover the increased costs of SFAS-106 implementation.

The ETI report states that SFAS-106 costs "were reflected in the share prices of the LEC and other firms evaluated by the FCC for the rate of return represcription upon which the LEC price cap plan was based" and that "the Commission should fairly conclude that SFAS-106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers."[4] ETI supports this statement by noting that "a large data base of health care prices, costs, employee contributions and co-payments, eligibility requirements, deductibles and other insurance requirements" was available to "actuaries, securities analysts, insurance and benefits consultants and any other analyst who may have cared to compute potential long-term health care costs for any segment of the

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4 Opposition of the Ad Hoc Telecommunications Users Committee to Direct Cases, filed July 1, 1992, at Appendix I, p.2.

population."[5]

In addition, the ETI report states that:

> the FCC's represcription of the industry-wide rate of return for LECs explicitly relied upon Institutional Brokers Estimate Service (IBES) data on dividends, earnings and stock prices as part of the discounted cash flow analysis used to establish the prescribed return on equity. IBES data were determined by the FCC to be a reasonable expectation of investor expectations.[6]

The ETI report neglects to point out that if the prospect of SFAS-106 costs would impact stock prices, it should also impact dividend and earnings growth expectations, for it is these very expectations which affect stock prices. It follows then that, just as the pressure on stock prices would presumably be downward, so would the impact on dividend and earnings growth expectations (absent exogenous treatment, obviously). Therefore, if stock prices are lower and if dividend and earnings expectations are lower, it is entirely possible, even likely, that the cost of equity would be largely unaffected, certainly not higher as ETI contends.[7]

MCI makes the same error as ETI. Both consider one variable in the equation, that is, purported stock price effects. Curiously, however, they do acknowledge the impact on earnings expectations, but not in any quantitative way, when they state

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5 Id. at p.11.

6 Id.

7 The opposing parties all reference the Discounted Cash Flow (DCF) analysis when discussing the cost of equity, whereby cost of equity is the sum of the dividend yield and expected growth in dividends.

that "(a)ny negative consequence to earnings or profitability caused by the expectations of SFAS-106 costs was recognized by the market participants and resulted in downward adjustment to the price of the stock."[8] This lack of recognition of the "negative consequence to earnings" is amply demonstrated in the affidavit prepared by Professor Drazen where the author refers only to "the effect that the anticipated adoption of SFAS-106 may already have had on the price of the LECs' stock and hence on the rate of return to capital on which current rates are based."[9]

Apparently Professor Drazen is not completely unaware of the effect on growth expectations, as he goes on to state:

> (t)he cost of equity calculated by the DCF formula is the sum of the dividend yield and an estimate of the long-term growth in dividends G. A future regulation such as SFAS-106, which is anticipated to induce a discrete downward adjustment in accounting profits when first adopted but whose exact initial impact is uncertain, should have a clear effect in reducing the stock price but a far less clear effect on estimates of G.[10]

Drazen further contends that:

> when there is agreement on the direction of the effect of a regulation on profitability, but uncertainty about its exact impact before it is adopted, there will be a fall in the stock price, and hence an increase the yield (sic) and in the cost of equity as measured by the DCF formula before the regulation is adopted.[11]

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8 Opposition of MCI Telecommunications Corp. Direct Cases, filed July 1, 1992, at Appendix A, p.15. [MCI Appendix A.]

9 Id. at p.2.

10 Id. at p.3.

11 Id. at p.4.

Is the Commission to believe, then, that because there is purportedly uncertainty regarding the magnitude of the effect on G, it is to be ignored? Surely, without adequate rate recovery, there is no such uncertainty regarding the direction of the impact on G. In fact, later on, Professor Drazen admits there is some uncertainty in the measure of the "increase in the present discounted value of anticipated retiree health liabilities" presented in the referenced Mittelstaedt and Warshawsky study [Warshawsky] when he allows "(t)his estimate has a large confidence interval however."[12] He further states that "(t)he Warshawsky estimates suggest that with the high degree of uncertainty regarding the impact of SFAS-106 before it was adopted, there was a clear depressing effect on stock prices."[13]

It is, therefore, hard to reconcile this admitted "uncertainty" and "large confidence interval" with Professor Drazen's premise that there will be a "clear effect in reducing the stock price"[14] and his decision not to incorporate any effect on dividend and earnings growth expectations. Clearly, this sort of implementation of the DCF would lead to upwardly biased estimates of the cost of capital and not a "true" adjustment to the cost of capital as postulated by the author.

The Warshawsky estimates are founded on unsupported

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12 Id. at p.5.

13 Id.

14 Id. at p.3.

assumptions, which may be the reason for the lack of statistical robustness in the results. The authors themselves admit this imprecision in their own abstract. "(R)esults suggest that market estimates of the liabilities are imprecise. To the extent that the imprecision is due to insufficient accounting disclosures, significant price adjustments, <u>upward and downward</u>, may occur when information required by a new accounting standard is disclosed."[15]

Drazen's contention that "(t)he possibility that an anticipated future cost increase will be reflected in a higher current cost of equity is noncontroversial in theory,"[16] is contradicted in the same article used in Warshawsky's paper:

> Although many corporate executives concede that the new rule would slash reported earnings and reduce book values substantially, the FASB proposal so far has caused little stir on Wall Street. ... Shrugs Lee Seidler, an accounting specialist with Bear Stearns, "It will be a big yawn."[17]

Additional evidence on the lack of consensus among analysts and investors of the impact of SFAS-106 on stock prices at the time of the Commission's represcription is evident in the same article:

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15 M. Warshawsky, "The Impact of Liabilities for Retiree Health Benefits on Share Prices," Finance and Economics Discussion Series paper 156, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., April 1991, Abstract. (Emphasis added.)

16 MCI Appendix A at p.4.

17 Henriques, Barron's, April 17, 1989 at p.8.

> Only about a fourth of the corporations surveyed in Foster Higgin's annual health care benefits survey have even a rough idea of what their potential liabilities would be under the FASB proposal, says Pat Wilson. "Do they know the general magnitude? Yeah, they have a feel for it. They know if it's bigger than a bread-box, smaller than a battleship. But do they know what the effect will be on their income statement over time? No. The percentage that really knows that is much, much lower."
>
> But, however slow corporations have been to assess the potential consequences of the FASB rule, they're leagues ahead of Wall Street.
>
> "I don't think anyone even has a good idea of how to start dealing with this, how to develop the logic by which they can anticipate who would be affected," admits Robert Willens, a senior vice president at Shearson Lehman Hutton. There's a large body of people who think this will never get implemented, so they just haven't given it much thought."[18]

The sole quote relied on by Warshawsky, by an analyst at Salomon Brothers, was immediately followed in the article by this statement:

> Willens doesn't buy that. "I don't see how that could be the case when people are just now beginning to get an idea of the potential implications," he protests. "They're not even close to being reflected in the stock price."[19]

The underlying weakness in all of the arguments made to support the view that the cost of capital, as estimated by the Commission, already contains a premium to account for SFAS-106 costs is quite straightforward. Any perceived stock price effects are caused by possible changes in dividend and earnings growth assumptions. The stock price effects do not materialize on their own, the two go hand-in-hand. Even Professor Drazen

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18 Id.

19 Id. at p.9.

CERTIFICATE OF SERVICE

I, Robyn L.J. Davis, do certify that on July 31, 1992 copies of the foregoing Rebuttal to Oppositions to Direct Case of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

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UNITED STATES TELEPHONE ASSOCIATION

Analysis of Impact of SFAS 106 Costs on GNP-PI

Supplemental Report: Responses to Objections Raised Regarding Original Study

Godwins

July, 1992

INTRODUCTION

Earlier this year, Godwins submitted a report to the United States Telephone Association (USTA) analyzing the impact of SFAS 106 on the GNP-PI, and, in particular, the extent to which the GNP-PI will reflect the increase in costs experienced by the Price Cap LECs as a result of adopting the new accounting standard. This report was placed on the record with the FCC in Bell Atlantic's Tariff Transmittal filed on February 28, 1992 (Transmittal No. 497) and was also included in U.S.West's Tariff Transmittal filed on April 3, 1992 (Transmittal No. 246).

In their filings with the FCC, several organizations took exception to the findings of that report. In particular, AT&T, MCI and the Ad Hoc Telecommunications Users Committee raised several objections with regard to various aspects of the study. The USTA has asked Godwins to provide a detailed response to each of those objections.

The purpose of this Supplemental Report is to provide the USTA with those responses. We have organized our responses into three sections, corresponding to the three different types of objections raised.

While the objections raised were numerous, this material will demonstrate that none of the objections raised should cause the Commission to have any doubts regarding the soundness of the study, or the validity of the results.

Respectfully Submitted,

Peter J. Neuwirth, F.S.A., M.A.A.A.

Andrew B. Abel, Ph.D.

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SECTION I

RESPONSE TO OBJECTIONS REGARDING OVERALL STUDY

A. Definition of Double Count

There were two objections raised with respect to the manner in which we defined the potential sources of double counting and what sort of analysis would be required to eliminate any double counting in determining the portion of the LECs' SFAS 106 costs that should qualify for exogenous treatment.

AT&T Contention - (Pages 6 and 7) "The LEC's have failed to demonstrate that the Commission's third criteria is met. To the contrary, the LECs' requests for exogenous treatment appear to reflect certain OPEB costs that will be reflected in the GNP-PI ... The double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation. If the SFAS 106 accrual is afforded exogenous treatment, the amount of the accrual will be increased automatically in future periods due to growth in inflation expressed by the GNP-PI component of PCI.** Therefore, if inflation is included in both the exogenous cost component and GNP-PI, an LEC would be compensated twice. Although the LECs recognize this problem, no carrier has met its burden of showing that it has effectively removed this double count."

Response - AT&T's description of what it considers the source of potential double counting in the LECs' request for exogenous treatment for increased costs due to SFAS 106 demonstrates some confusion as to both the double count problem and the Godwins Report. Essentially AT&T suggests that double counting may arise from two separate sources:

(1) Increases in the PCI due to increases in the GNP-PI caused by "firms with OPEB liabilities reflect(ing) those costs through higher prices."

(2) Automatic increases in the exogenously treated portion of SFAS 106 accrual "due to growth in inflation expressed by the GNP-PI component of PCI."

The first source of potential double count, while a valid concern, is precisely the factor that the Godwins Report directly and thoroughly addresses. The first paragraph of page 1 of the Godwins Report explicitly states this as the primary objective of the study. As will be seen in the responses to specific criticisms of the Godwins Report, no respondent has raised any issue which, upon scrutiny, casts doubt on any of the basic findings of the study. Therefore, the Commission should accept the Report's conclusions that (a) this source of double count accounts for 0.7% of the increase in costs attributable to SFAS 106, (b) another 14.5% of the increase will be recovered through a reduction in the national wage rate, and (c) the remaining 84.8% of such increase in costs will remain unrecovered unless exogenous treatment is granted on this amount.

The second alleged source of double counting simply doesn't exist, and is the result of confusion over exactly what the LECs are requesting. While it is true that the SFAS 106 expense calculation includes the present value of future inflation, and that the expense calculated under SFAS 106 can be expected to increase each year at something close to the rate of inflation, SFAS 106 expense is not what the LECs are requesting exogenous treatment on. It is the increase in expense due to the SFAS 106 accounting change that should be afforded exogenous treatment. This is an absolutely critical distinction which is missed by AT&T. Retiree medical plans were sponsored by firms before and after SFAS 106 was issued. It is only the accounting for those plans that has changed, and it is the increase in costs associated with this change in accounting that must be evaluated.

__MCI Contention__ - (Page 30)

"If one were to include SFAS 106 costs through exogenous treatment, the revenues resulting from the increase in the price cap index to account for these costs would also increase each year by the GNP-PI, as adjusted for the productivity factor. The problem is that SFAS 106 costs have already been adjusted for future inflation...Therefore, the impact of medical care cost inflation has already been counted. As such the amount offered by the LEC's has been inflated to reflect future medical costs. To include these costs again within the price cap formula through exogenous treatment, and treat them by the full amount of GNP-PI which has medical inflation embedded as well is tantamount to double counting the medical care inflation rate."

__Response__ -

This contention is virtually identical to the second "source" of double counting outlined by AT&T on page 7 of its filing with the Commission. Rather than repeat our response to that contention, we would just point out that, like AT&T, MCI seems to have failed to grasp the point that the LECs are not asking for exogenous treatment on the SFAS 106 expense, rather they are asking for exogenous treatment on that portion of the __increase in expense__ due to the mandated accounting change, which will not already be reflected in GNP-PI increases __caused by that accounting change__.

B. <u>Avoidance of Double Count</u>

Two respondents suggested "better" ways of determining the extent of the double count problem, and therefore "better" ways of determining the appropriate portion of SFAS 106 costs that should qualify for exogenous treatment.

<u>AT&T Contention</u> - (pp. 13 - 14)

"....The Commission should require the LEC's to use an alternative that is both a simpler and more reliable means for correcting the double count. AT&T suggests that the appropriate method for removing the double count between the SFAS 106 accrual and the GNP-PI term in the price cap formula is to remove the impact of expected changes in GNP-PI from the SFAS 106 accrual. This can be accomplished in a straightforward manner by requiring the LEC's to subtract the expected rate of change of GNP-PI from the health care inflation component in the SFAS 106 accrual. The Commission should specify the changes in GNP-PI over the SFAS 106 forecast period. Current estimates is (sic) that GNP-PI will increase approximately 4% over the long term."

<u>Response</u> -

That AT&T should suggest such an illogical and erroneous "solution" to the double count problem is indicative of a failure to understand the true source of any potential double counting. As discussed earlier, potential double counting is not related to the fact that SFAS 106 costs are calculated by discounting future medical inflation back to the present. As discussed on page 2 of this material, double counting will only arise to the extent that the increased costs companies will bear, as a result of the change in accounting method required by SFAS 106, will also cause an increase in GNP-PI.

The fact that the AT&T "solution" does not address the true source of potential double counting is illustrated in the following example, where the AT&T solution is shown to produce an identical exogenous adjustment in two factually different circumstances, where logic would dictate different exogenous adjustments be applied.

In the second footnote on page 13 of its filing, AT&T estimates that its "solution" of allowing exogenous treatment for SFAS 106 accruals, calculated using a medical trend rate 4% lower than the actual rate used by the LECs for their financial statements, might result in approximately 55% of a given LEC's actual SFAS 106 accrual being afforded exogenous treatment. Now let us consider two hypothetical scenarios:

(1) Every U.S. firm, LECs and non-LECs alike, have identical demographic makeups and provide identical retiree medical benefits. Thus, in this case, presumably every U.S. firm would experience the same increase in labor costs due to SFAS 106. In addition, under this scenario, it is assumed that all labor cost increases associated with SFAS 106 are completely reflected in the GNP-PI, as companies raise their prices to recover those costs.

(2) The LECs are the <u>only</u> firms subject to SFAS 106, and/or the additional costs due to the adoption of SFAS 106 costs are never reflected in the GNP-PI.

In the first scenario, it is obvious that the increased labor costs due to SFAS 106 experienced by the LECs would be fully and completely reflected in the GNP-PI (the Godwins Report, of course, demonstrates that this hypothetical situation does not exist), and thus no exogenous adjustment would be required. In fact, in this hypothetical scenario, providing any exogenous adjustment would result in a complete double count. Yet in this circumstance, the AT&T approach of allowing recovery of SFAS 106 costs, calculated using a lower trend rate (medical inflation minus 4%), would, as noted above, result in allowing exogenous treatment on 55% of SFAS 106 accruals.